

FISCAL NOTE

Bill #: SB0133 **Title:** Capital formation act for venture capital

Primary Sponsor: Mangan, J. **Status:** As Amended in Senate Committee - 2nd amendment

Sponsor signature	Date	David Ewer, Budget Director	Date
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Fiscal Summary

	<u>FY 2006 Difference</u>	<u>FY 2007 Difference</u>
Expenditures:		
General Fund	\$132,107	\$65,259
State Special Revenue	\$0	\$65,259
Revenue:		
State Special Revenue	\$0	\$65,259
Net Impact on General Fund Balance:	(\$132,107)	(\$65,259)

<input type="checkbox"/> Significant Local Gov. Impact	<input checked="" type="checkbox"/> Technical Concerns
<input type="checkbox"/> Included in the Executive Budget	<input checked="" type="checkbox"/> Significant Long-Term Impacts
<input checked="" type="checkbox"/> Dedicated Revenue Form Attached	<input checked="" type="checkbox"/> Needs to be included in HB 2

Fiscal Analysis

ASSUMPTIONS:

Department of Commerce (DOC)

1. SB 133 establishes the Montana Equity Capital Investment Act to provide investment incentives to nourish creation of a private seed and venture capital industry to fund academic, technological, and innovative companies by creating a Montana Equity Fund and Montana Equity Capital Investment Board (Board); authorizes the issuance of tax credits to investors in the Montana Equity Fund; requires the Board to charge an annual fee to the designated investor group for administration of the Act. Section 4 creates the board, which consists of five voting members and administratively attaches said Board to the Department of Commerce as provided in 2-15-121, MCA.
2. Board members must be compensated for expenses and mileage, but they may not receive a director's fee, per diem, or salary for their service (Section 4). For the purposes of this fiscal note, it is assumed the board will meet four times a year at an estimated cost of \$250 per member or \$5,000 each fiscal year ($(\$250 * 5) * 4$ meetings).
3. The Board will charge a fee to the designated investor group once it is selected. The Department of Commerce assumes it will take all of FY 2006 and six months of FY 2007 (18 months) to appoint the Board, draft and adopt administrative rules, and select the designated investor group. Therefore, it is also

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assumed there would be no revenue from the annual fee established in Section 7 of the bill until the second half of FY 2007.

4. Section 5(4) provides a guaranteed return on investment to investors in the Montana Equity Fund because the State of Montana will issue tax credits that can be redeemed to cover the principal investment in case of loss, interest on the investment, actual tax on investment earnings, and other expenses that are undefined in the bill. Although the State of Montana is the principal risk taker in this legislation, it is assumed there will be no tax credits redeemed during the 2007 biennium.
5. Section 5 states that the Board may hire staff, engage consultants, expend funds, and enter into contracts and terminate contracts. 1.00 professional level FTE (pay band 7) and 1.00 administrative assistant FTE (pay band 5) would be required to administer the affairs of the Board, and manage and monitor contracts and redemptions of tax credit certificates. It is assumed the 1.00 professional level FTE would be filled on July 1, 2005 and the 1.00 administrative assistant FTE would be filled on January 1, 2006. Personal services costs would be \$79,654 in FY 2006 and \$100,514 in FY 2007. In addition, it is assumed that a professional contract to provide due diligence would be needed during the selection process for the designated investor group during FY 2006 in the amount of \$20,000. Total operating expenses are estimated to be \$52,453 in FY 2006 and \$30,004 in FY 2007. Operating expenses include board and selection committee member travel expenses, contractual expenses for legal and financial assistance, along with miscellaneous operating expenses which include preparation, printing, and distribution of an annual report, and review of the annual audit.

Department of Revenue (DOR)

6. This bill creates the Montana Equity Fund, and its associated subfund the Montana Evergreen Fund, in order to attract venture capital to the state. It also creates the Montana Capital Investment Board which is charged with selecting, certifying, and contracting with a Designated Investment Group (DIG). DIG will organize, capitalize, and administer the Montana Equity Fund by contracting with investors who will provide the capital for the fund, and will make investments in start-up businesses and other ventures.
7. Contracts between the DIG and investors will provide for a specific rate of return of, and return on, investments made by the group. If the actual rate of return of and return on investment is less than the contractual rates, then investors become "certificate holders". These certificates entitle investors to tax credits against either individual income taxes, corporation license taxes, or insurance premiums taxes in an amount equal to the differential between the stated and actual rates of return. Furthermore, these certificates can be sold to other individuals who may claim the tax credit.
8. Investment income in excess of contractual rates of return with investors and any other contractual obligations is deemed "proceeds". Proceeds must be reinvested until the Montana Equity Fund has invested or reserved for investment \$60 million in seed and venture capital partnerships or other entities. After that time, proceeds are distributed 75 percent to the Montana Evergreen Fund, and 25 percent to the state general fund.
9. Once the Montana Evergreen Fund has invested or reserved for investment \$60 million, distribution of all the proceeds must be made to the state general fund.
10. There are three means by which this proposal may impact state general fund revenues. First, in the event that contractual rates of return are greater than actual rates realized, investors may be awarded certificates allowing them to offset income tax liabilities, thereby reducing general fund collections. Second, once the Montana Equity Fund has capitalized at least \$60 million of investment, any proceeds in excess of contractual obligations is distributed 25 percent to the state general fund, thereby increasing state general fund collections. Similarly, once the Montana Evergreen Fund has invested or reserved for investment \$60 million, proceeds in excess of contractual obligations are distributed 100 percent to the state general fund.

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11. Given the process for and time needed to create the Montana Capital Investment Board and the Designated Investment Group, and the time it will take to actually receive initial investment capital, invest that capital and begin to realize returns of and returns on investments, it is unlikely that this proposal will have any impact on state general fund revenues in the 2007 biennium. This is particularly true given that Section 8 of the bill provides that the tax credits associated with investment returns cannot be claimed prior to July 1, 2010.
12. It is also unlikely that either the Montana Evergreen Fund or the Montana Equity Fund will reach the \$60 million level of investment in the 2007 biennium. Any distribution of proceeds to the state general fund is likely to occur after the 2007 biennium.
13. The Department of Revenue has no administrative costs associated with this proposal.

FISCAL IMPACT:**Department of Commerce (DOC)**

	<u>FY 2006</u> <u>Difference</u>	<u>FY 2007</u> <u>Difference</u>
FTE	1.50	2.00
<u>Expenditures:</u>		
Personal Services	\$79,654	\$100,514
Operating Expenses	<u>52,453</u>	<u>30,004</u>
TOTAL	\$132,107	\$130,518
<u>Funding of Expenditures:</u>		
General Fund (01)	\$132,107	\$65,259
State Special Revenue (02)	<u>0</u>	<u>65,259</u>
TOTAL	\$132,107	\$130,518
<u>Revenues:</u>		
State Special Revenue (02)	\$0	\$65,259
<u>Net Impact to Fund Balance (Revenue minus Funding of Expenditures):</u>		
General Fund (01)	(\$132,107)	(\$65,259)
State Special Revenue (02)	0	0

LONG-RANGE IMPACTS:**Department of Commerce**

1. Tax credits can only be redeemed if the Montana Equity Fund does not generate a return on investment at least equal to the return approved by the Board pursuant to Section 5. The potential financial impact related to the tax credits issued pursuant to Sections 8 and 9 of the bill can vary from no impact to \$60 million depending on the performance of the Montana Equity Fund and the return on investment generated for the equity fund investors that have been issued contingent, deferred tax credits.
2. SB 133 restricts the redemption of the contingent, deferred tax credits to \$12 million a year in the case of a major loss or series of losses by the Montana Equity Fund resulting in its inability to provide an approved rate of return to the equity fund investors who have been issued tax credits.

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3. If the Montana Equity Fund exceeds the estimated return on investment, there is a possibility that the state can receive proceeds to the general fund. "Proceeds," means revenue arising from the designated investor group's investments after deducting contractual obligations to it's and the Montana equity fund's investors. Contractual obligations include but are not limited to fees, reimbursement of expenses, and up to 10 percent of net realized gains that may be allocated and contractually obligated to the designated investor group and specified Montana equity fund investors. The Montana Equity Fund would have to achieve exceptional returns for itself and equity investors before proceeds could be realized by the state.

Department of Revenue

4. Over time, the state general fund will be impacted in the two ways discussed above. The net effect on the general fund over time will be the difference between the amount of credit claimed, if any, against income taxes for investments that fail to return the contractual rate, and the amount of revenue deposited in the general fund from proceeds in excess of contractual rates of return after the fund has been capitalized at the \$60 million level.

TECHNICAL NOTES:

Department of Commerce

1. Section 10 (2) requires the Board to include in its contract with the designated investor group a provision that states "For every \$1 invested by the Montana equity fund in its aggregate portfolio of fund investments, the designated investor group shall seek to cause a minimum of \$1 of equity capital or near-equity capital to be invested in Montana businesses or projects or primary sector businesses, as defined in 39-11-103, MCA, that are headquartered in Montana or have at least 50 per cent of gross sales receipts from products principally produced in Montana or services provided from a Montana location". The controlling language, "shall seek to cause", does not require any level of investment in Montana.
2. There is the possibility that the Montana Equity Fund Board may have to terminate the contract with the "designated investor group" for cause due to performance issues. Because the Montana Equity Fund is making loans and equity investments using cash from equity fund investors that have been issued contingent, deferred tax credits, the principal recourse in the case of a contract termination with the fund manager is to transfer the investment portfolio of the Montana Equity Fund to a newly designated investor group. The portfolio would consist of equity investments and loans that may not have an asset value equal to the contingent, deferred tax credits issued.
3. Section 4(9) states: "The board is attached to the department of commerce for administrative purposes as provided in 2-15-121." This bill would be better coordinated with the provisions of 2-15-121, MCA if section 4(9) were amended as follows:
"The board is attached to the department of commerce for administrative purposes only and unless inconsistent with this section, the provisions of as provided in 2-15-121 apply. The department shall provide staff support to the board and act as a liaison between the board and other state or federal agencies."
4. Section 5(1) states: "The board may hire and fire staff, engage consultants, expend funds, enter into contracts, or terminate contracts." Section 2-15-121(3), MCA requires a department to provide staff for agencies that are attached to it for administrative purposes only and prohibits attached agencies from hiring their own staff. To be consistent with 2-15-121(3), MCA, Section 5(1) should be amended as follows:
"The board may ~~hire and fire staff,~~ engage consultants, expend funds, enter into contracts, or terminate contracts."